

ORIGINAL



BEFORE THE ARIZONA CORPORATION COMMISSION

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IN THE MATTER OF THE APPLICATION OF
DUNCAN RURAL SERVICES CORPORATION
FOR A RATE INCREASE.

DOCKET NO. G-02528A-05-0314

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IN THE MATTER OF THE APPLICATION OF
DUNCAN RURAL SERVICES CORPORATION
FOR APPROVAL OF A LOAN IN THE AMOUNT
OF \$400,000.

CLOSING BRIEF

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Duncan Rural Services Corporation ("DRSC" or the "Association") submits this Closing Brief in support of its rate and long-term debt Applications. DRSC will focus primarily on the four issues on which it and Staff disagree: (1) revenue requirements, (2) rate design, (3) changing the way DRSC administers its gas adjustor clause and (4) the amount of long-term debt the Commission should authorize.

Introduction

The Administrative Law Judge ("ALJ") is very familiar with the difficulties faced by DRSC having heard three of its four rate cases over the past 12 years. For brevity's sake, we will not repeat here the difficulties of its 15-year-plus history as a small, non-profit association delivering gas in Greenlee County (see Opening Statement, HR TR, pp. 7-14). The Association and Staff agree that DRSC needs to address its financial problems.

1 Mr. Shilling described it this way:

2 The other thing I might say, Ms. Rodda, you have been in all of our
3 Duncan Valley rate cases that we have had and you know the struggle that
4 we have had with [the Duncan Valley rate cases]. We had excess funds
5 from the PD settlement. We no longer have those excess funds.

6 So Duncan Rural is going to have to get to the point very quickly that it
7 can borrow from a third-party lending agency other than Duncan Valley.

8 ***

9 Q. [by Ms. Rodda] Okay. All right. So one of my questions I had from
10 before and you just touched on this was, does Duncan Valley electric have
11 the funds to lend...?

12 A. Today we do but we would not anticipate much more than two to three
13 years that we would be able to fund the cash for Duncan Rural Services.
14 (HR TR, pp. 98-100.)

15 It is clear that meaningful solutions for the Association must be devised and approved
16 now. Each one of DRSC's recommendations on revenue requirements, rate design, a change in
17 gas clause administration and a realistic level of long-term debt are designed to place the
18 Association in a position that it will be able "to stand on its own two feet" and continue to
19 provide safe, reliable and adequate service to its members.

20 **I. Revenue Requirements**

21 Staff recommends that DRSC begin to build equity. The Association agrees. That is one
22 reason why the Commission should approve the rates it has requested, including two additional
23 5% step increases to take effect on January 1, 2007 and January 1, 2008.

24 Attached as Exhibit A is Mr. Wallace's Rejoinder Schedule A-2 (in evidence as
Exhibit A-4) which sets forth details on the requests. DRSC asks that the Commission authorize
a rate of return of 13.56% (l. 11) on its agreed rate base of \$758,057 (l. 10), but that \$32,436
(l. 15) of the requested relief be deferred for implementation in 2007 and 2008 as reflected in the

1 two right-hand columns of Exhibit A. This process is similar to the step increases which the ALJ
2 recommended and the Commission authorized for the Arizona Electric Power Cooperative and
3 Southwest Transmission Cooperative last year.

4 Both Mr. Wallace and Mr. Shilling discussed the multiple reasons supporting the request
5 (HR TR, pp. 52-60, 67-70, 105-106). Briefly to summarize, it is consistent with the
6 Commission's stated preference for smaller and more regular rate increases. It will also save
7 Commission time and resources and avoid about \$60-70,000 in expense which DRSC would
8 incur in processing two rate cases. To place those savings in context, they are about the same as
9 the roughly \$64,000 in total margins DRSC might earn in 2008 (Ex. A, l. 6, right column) and
10 are almost as much as the Association's one-year capital budget requirement of \$80,000.

11 Historically, there is no disagreement that DRSC revenues simply have not kept pace
12 with its expenses and its required capital expenditures. The revenue requirements request will
13 help address the combined effect of both its dwindling customer base as well as its rising
14 expense levels between the close of the test year and rate implementation. The request assumes
15 a more realistic interest level of 5% on the additional borrowings necessary to repay the currently
16 outstanding advances from Duncan Valley as well as to fund this year's repair and replacement
17 program. About one-third or \$5,000 of the \$16,000 in deferred rates is needed to pay the
18 increased interest expense on loan funds for this year's capital program. Finally, the
19 Association's request provides a timely, efficient and meaningful response to Staff's
20 recommendation that DRSC should build equity. DRSC requests that the Commission approve
21 the revenue requirements recommendations and 5% step increases set forth on Exhibit A.

1 **II. Rate Design**

2 Attached as Exhibit B are the rates which DRSC asks be authorized (Exhibit A-5). The
3 Association and Staff agree on the monthly service charges for each service category and the
4 service charges set forth at the bottom of the exhibit.¹

5 The Staff/DRSC disagreement on rate design focuses on two issues. Staff recommends
6 that (1) there be distinct, as opposed to uniform, commodity rates for each class and (2) the rate
7 design should be changed from the summer/winter rate differential in effect on the system for the
8 past four years and which was approved by the Commission in 2002.

9 The impact on the irrigation class and on DRSC's revenues is the greatest concern with
10 the Staff proposal. Under its plan, the 250-425 cfh irrigation class contributes roughly eight
11 times as much as the residential class return on rate base (Revised Schedule G-2, Exhibit S-2).
12 As Mr. Wallace testified, DRSC's current and proposed design recognizes that the irrigation
13 class uses very little gas during the peak winter months and does not cause capacity and capital
14 investment system costs. DRSC's rate design also attempts to preserve the revenues from its
15 irrigation customer base which is very price sensitive: "if they drop off the system we will lose
16 the entire revenue from that customer [class]." (HR TR, p. 40, ll. 14-23.) Referring to Staff's
17 Exhibit S-2, that would represent an operating income loss of \$25,925 or about 60% of the
18 Association's expected total margins from this case.

19 Mr. Shilling stated that this devastating loss of revenues is not a hypothetical concern:

20 This year we had three of our approximately 20 irrigators shift from natural gas to
21 electric permanently, and all of our natural gas customers have the ability to
irrigate with electric. They are dual-facility customers.

22 ***

23 ¹ Although not a preferred result, Mr. Wallace testified that the Association could accept Staff's recommendation of
24 3% as the interest rate on customer deposits (HR TR, pp. 30-31).

1 Q. [by Mr. Grant] Are they price sensitive?

2 A. Yes, they are.

3 Q. Can they also shift the time in which they grow crops or perhaps select
4 different crops to—which grow in different seasons?

5 A. Yes, they can, and that's part of the reason for the summer-winter
6 differential. We try to discourage our irrigators from irrigating in the
7 wintertime because that would probably make us have to invest more
8 money in plant for the capital and the demand. (HR TR, p. 76, l. 13-p. 77,
9 l. 9.)

10 In responding to questions from the ALJ, Mr. Irvine indicated that Staff was not aware of
11 this evidence concerning the irrigator's capability and practice of fuel switching in making its
12 rate design recommendation (HR TR, pp. 174-175). Although Staff's well-intentioned objective
13 was to assist residential consumers, the evidence demonstrates it will have just the opposite
14 effect—reducing revenues, increasing necessary capital expenditures and, as a result, increasing
15 rates for the residential class.

16 Finally, another advantage of the rate design proposed by DRSC is that it has been in
17 effect for the past four years and, thus, meets a key cost-of-service goal: uniformity. It would
18 also avoid a substantial impact on the local school district—the only customer taking service
19 under the greater than 425 cfh rate (A-3, p. 8, ll. 11-21). Rates authorized in this case would take
20 effect after the peak season—minimizing Staff concerns about the winter/summer differential
21 impact (HR TR, pp. 70-71). Further, Mr. Shilling testified that the Association has not received
22 complaints because of the seasonal rate differentials and it offers a levelized bill payment
23 program allowing customers to regularize payments throughout the year (HR TR, p. 84). The
24 Association would request that the Commission approve the rates set forth in Exhibit B.

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1 and do see great variability under the current system (HR TR, p. 167, ll. 4-12). Demonstrative of
2 that fact is that consumers have twice in the recent past seen sudden jumps of 41 cents and 45
3 cents per therm in just one month—more than four times the variability and volatility allowed
4 under DRSC's proposal. The Association requests that the Commission approve a change in its
5 PGA clause administration procedures as described above.

6 **IV. Long-Term Debt Level**

7 The last issue on which Staff and the Association disagree is the level of long-term debt
8 which should be authorized. DRSC recommends \$600,000, while Staff's position is that only
9 about \$330,000 should be authorized.

10 The \$98,000 portion of the differential between the DRSC and Staff positions would be
11 used to fund this year's capital repair and replacement program. It essentially updates DRSC's
12 original finance application which was filed in 2003. The Association, however, requested the
13 Commission delay action on the request, because this rate case needed to be processed first in
14 order to provide funds to pay the debt service on the requested debt.

15 Apparently Staff opposes this request because issuing "any additional long-term debt
16 would further exacerbate Duncan's excessively leveraged capital structure..." (Exhibit S-4, p. 2,
17 ll. 15-16). While this may be true, it doesn't change the fact that additional funds are needed
18 now for required repairs and replacements on the aged system and no one contests that fact.
19 Denial of the request might improve DRSC's equity position on paper, but it will seriously
20 jeopardize its ability to continue to provide safe, reliable and adequate service. Neither the
21 Commission nor Staff nor the Association wants to see a return to the days before this system
22 was purchased when it was in "serious disrepair and...cited by the Staff's pipeline safety section
23
24

1 for numerous violations.” (Decision No. 58356, p. 3.) The \$98,000 in additional long-term debt
2 is necessary to avoid that result.

3 The remaining approximately \$170,000 differential between the DRSC and Staff
4 positions turns on Staff’s position that this amount of Duncan Valley Electric Cooperative
5 advances to DRSC funded operating expenses not capital improvements. As a general matter,
6 DRSC does not disagree with Staff that normally loan funds should not be used to fund operating
7 expenses. They should be paid from operating income or, in the case of a for-profit utility, from
8 capital infusions from stockholders. However, as a factual matter, in the case of a non-profit
9 corporation like DRSC, there are, of course, no stockholders and no other source of funds for
10 DRSC to continue to meet its obligations than the advances it received from Duncan Valley. As
11 a legal matter, the statutes expressly give the Commission the authority to authorize debt to cover
12 operating expenses: “except as otherwise permitted in the order, such [loan] purposes are not,
13 wholly or in part, reasonably chargeable to operative expenses or to income.” A.R.S. § 40-302.A
14 (emphasis supplied).

15 This case is an ideal and a unique one for the Commission to exercise that power. The
16 challenges facing the Association have been daunting. It has filed four rate cases in the past 12
17 years. Each documents the extraordinary challenges it has faced in operating this system,
18 including much larger than expected capital requirement needs and the need to correct its
19 predecessor’s billing factor error when discovered, which negated much of the relief granted in
20 one of those cases. DRSC filed a timely request for loan approval of the advances, but had to
21 defer it for processing of this rate case. Duncan Valley and its members stepped in to assist. As
22 already discussed, many of the advances required by DRSC since the last rate case have been
23
24

1 because of very high natural gas prices² and a PGA recovery mechanism which does not allow
2 timely matching of expense recovery to expense incurrence. All of these factors have been
3 beyond both DRSC and Duncan Valley's control.

4 The Commission should authorize the additional \$600,000 in long-term debt to meet past
5 and current capital expenditure needs and amounts spent in good faith to meet some operating
6 expenses which were beyond DRSC's control. To force a \$170,000 capital infusion by Duncan
7 Valley's members under these circumstances is unwarranted and unfair.

8 On a related matter, Staff has also suggested that advances from Duncan Valley Electric
9 Cooperative to DRSC should be discontinued. While the Association agrees that is an important
10 goal and one of the primary reasons for its positions in this case, Staff's recommendation should
11 not be ordered. Mr. Shilling discussed the fact that even if the rates requested by DRSC are
12 granted, it still will not be able to cash flow operations in certain months and meet its obligations
13 as they come due (HR TR, pp. 79-84). That is particularly true in 2006, because the rates
14 ordered in this matter will not take effect until after the winter peaking season. Therefore, the
15 Association will not have the opportunity to marshal its cash resources in order to carry it
16 through the shoulder and summer months.

17 Conclusion

18 DRSC requests that the Commission enter its Order authorizing (1) the revenue
19 requirements and rate increases described in Exhibit A, (2) the rates set forth in Exhibit B,
20 (3) a change in gas adjustor procedures as described in Section III above and (4) \$600,000 in
21 long-term debt.

22
23 ² For example, Mr. Shilling testified at time of hearing that the under-collected bank balance was \$55,000 and would
24 probably increase to \$100-150,000 before the recently approved surcharge would begin to reduce that balance (HR
TR, pp. 101-102).

1 RESPECTFULLY SUBMITTED this 24th day of January, 2006.

2 GALLAGHER & KENNEDY, P.A.

3
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EXHIBIT A

PROPOSED REVENUE INCREASE
SUMMARY

Line	No.	Description	Per Books	Test Year As Adjusted	Proposed Rates	Proposed Rates With 5% Inc.	Proposed Rates With 10% Inc.
	1a.	Total Base Rate Revenue	\$ 644,167	\$ 319,136	\$ 485,841	\$ 502,060	\$ 518,278
	1b.	Total Other Revenue*	\$ 5,210	\$ 5,210	\$ 5,210	\$ 5,210	\$ 5,210
	1c.	Total Base Rate Revenue and Other Revenue	\$ 649,377	\$ 324,346	\$ 491,051	\$ 507,270	\$ 523,488
	1d.	Plus: Fuel Adjustor Revenue	\$ -	\$ -	\$ -	\$ -	\$ -
	1e.	Total Revenue Before Other Contract Margin Revenue	\$ 649,377	\$ 324,346	\$ 491,051	\$ 507,270	\$ 523,488
	1f.	Other Contract Margin Revenue	\$ -	\$ -	\$ -	\$ -	\$ -
	1g.	Total Revenue	\$ 649,377	\$ 324,346	\$ 491,051	\$ 507,270	\$ 523,488
	2.	Operating Expense Before Interest Exp. On L.T. Debt	\$ 708,298	\$ 371,375	\$ 412,943	\$ 412,943	\$ 420,713
	3.	Operating Margin Before Interest Exp. On L.T. Debt	\$ (58,921)	\$ (47,029)	\$ 78,108	\$ 94,326	\$ 102,774
	4.	Interest Expense on Long-Term Debt	\$ 14,973	\$ 39,187	\$ 39,187	\$ 39,187	\$ 39,187
	5.	Non-Operating Margins	\$ 110	\$ 110	\$ 110	\$ 110	\$ 110
	6.	Total/Net Margin	\$ (73,784)	\$ (86,106)	\$ 39,031	\$ 55,249	\$ 63,697
	7.	Total Long-Term Debt Principal Payment	\$ 45,305	\$ 55,421	\$ 55,421	\$ 55,421	\$ 55,421
	8.	Net TIER (Int Exp on L.T. Debt + Net Margin)/Total Int Exp on L.T. Debt	(3.93)	(1.20)	2.00	2.41	2.63
	9.	DSC (Net Margin + Depr Exp + Int Exp on L.T. Debt)/Prin&Int on L.T. Debt	(0.15)	(0.50)	1.35	1.52	1.61
	10.	Rate Base	\$ 758,057	\$ 758,057	\$ 758,057	\$ 758,057	\$ 758,057
	11.	% Return on Rate Base (Operating Margin / Rate Base)	-7.77%	-6.20%	10.30%	12.44%	13.56%
	12.	Total Proposed Revenue Increase Over Total Present Rates (Does not include Fuel Adjustor Revenue)	-	\$	\$ 166,705	\$ 182,923	\$ 199,142
	14.	% Increase In Total Adjusted Test Year Revenues			25.66%	28.16%	30.66%
	15.	Increase In Revenues			\$ 16,218	\$ 16,218	\$ 32,436

		SUMMARY OF FILING			
		PRESENT RATES		PROPOSED RATES	
	Per	TY as		Proposed	
	Books	Adjusted	Proposed	With 5 %	With 10 %
Revenues					
Sales Revenue of Gas - Base Rates & PGA	\$ 644,167	\$ 319,136	\$ 485,841	\$ 502,060	\$ 518,278
Other Operating Revenue	\$ 5,210	\$ 5,210	5,210	5,210	5,210
Total Revenue	\$ 649,377	\$ 324,346	\$ 491,051	\$ 507,270	\$ 523,488
Expenses					
Purchased Gas	\$ 325,260	\$ (0)	\$ (0)	\$ (0)	\$ (0)
Distribution Expense - Operation	\$ 147,723	\$ 154,097	\$ 154,097	\$ 154,097	\$ 154,097
Distribution Expense - Maintenance	\$ 52,766	\$ 54,824	\$ 54,824	\$ 54,824	\$ 54,824
Consumer Accounts Expense	\$ 58,103	\$ 60,129	\$ 60,129	\$ 60,129	\$ 60,129
Administrative and General Expense	\$ 54,952	\$ 56,520	\$ 56,520	\$ 56,520	\$ 56,520
Depreciation and Amortization Expense	\$ 49,645	\$ 49,645	\$ 49,645	\$ 49,645	\$ 49,645
Tax Expense - Property	\$ 19,639	\$ 19,639	\$ 19,639	\$ 19,639	\$ 19,639
Tax Expense - Other	\$ -	\$ -	\$ -	\$ -	\$ -
Tax Expense - Income taxes*	\$ (158)	\$ (23,846)	\$ 17,722	\$ 21,474	\$ 25,492
Interest Expense - Other	\$ 367	\$ 367	\$ 367	\$ 367	\$ 367
Total Operating Expenses	\$ 708,298	\$ 371,375	\$ 412,943	\$ 416,695	\$ 420,713
Interest Expense - Long-term Debt	\$ 14,973	\$ 39,187	\$ 39,187	\$ 39,187	\$ 39,187
Total Operating Expenses and Int on L.T. Debt	\$ 723,271	\$ 410,562	\$ 452,130	\$ 455,882	\$ 459,900
OPERATING MARGIN after Intr Exp on L.T. Debt	\$ (73,894)	\$ (86,216)	\$ 38,921	\$ 51,387	\$ 63,587
Non-Operating Margin					
Interest and Dividend Income	\$ 110	\$ 110	\$ 110	\$ 110	\$ 110
Capital Credits	\$ -	\$ -	\$ -	\$ -	\$ -
	\$ 110	\$ 110	\$ 110	\$ 110	\$ 110
TOTAL/NET MARGINS	\$ (73,784)	\$ (86,106)	\$ 39,031	\$ 51,497	\$ 63,697

EXHIBIT B

RATE DESIGN

<u>METER SIZES</u>	<u>Present Rates</u>	<u>Proposed Rates</u>	<u>Proposed Rates With 5% Incr.</u>	<u>Proposed Rates With 10% Incr.</u>
250 cfm & Below				
Monthly Service Charge	\$15.00	\$20.00	\$20.00	\$20.00
Winter Commodity Rate per Therm	\$0.44000	\$0.73000	\$0.77000	\$0.81000
Summer Commodity Rate per Therm	\$0.15405	\$0.26000	\$0.27600	\$0.28800
Above 250 cfm to 425 cfm				
Monthly Service Charge	\$22.50	\$30.00	\$30.00	\$30.00
Winter Commodity Rate per Therm	\$0.44000	\$0.73000	\$0.77000	\$0.81000
Summer Commodity Rate per Therm	\$0.15405	\$0.26000	\$0.27600	\$0.28800
Above 425 cfm to 1,000 cfm				
Monthly Service Charge	\$30.00	\$40.00	\$40.00	\$40.00
Winter Commodity Rate per Therm	\$0.44000	\$0.73000	\$0.77000	\$0.81000
Summer Commodity Rate per Therm	\$0.15405	\$0.26000	\$0.27600	\$0.28800

<u>Service Charges:</u>	<u>Present Rates</u>	<u>Proposed Rates</u>	<u>Proposed Rates</u>	<u>Proposed Rates</u>
Establishment of Service (Regular Hours)	\$ 35.00	\$ 35.00	\$ 35.00	\$ 35.00
Establishment of Service (After Hours)	\$ 50.00	\$ 50.00	\$ 50.00	\$ 50.00
Re-establishment/Reconnection of Service (Regular Hours)	\$ 50.00	\$ 50.00	\$ 50.00	\$ 50.00
Re-establishment/Reconnection of Service (After Hours)	\$ 75.00	\$ 75.00	\$ 75.00	\$ 75.00
After Hours Service Calls - Consumer Caused (Per Hour)*	\$ 50.00	\$ 50.00	\$ 50.00	\$ 50.00
Meter Re-read Charge (No Charge for Read Error)	\$ 30.00	\$ 30.00	\$ 30.00	\$ 30.00
Meter Test Fee	\$ 50.00	\$ 50.00	\$ 50.00	\$ 50.00
Insufficient Funds Check	\$ 20.00	\$ 20.00	\$ 20.00	\$ 20.00
Interest Rate on Customer Deposits**	3.0%	Variable	Variable	Variable
Late/Deferred Payment (Per Month)	0.0%	1.5%	1.5%	1.5%

* One hour minimum

** Variable Rate based on the Three Month Non-Financial Commercial Paper Rate as published by the Federal Reserve

Base Cost of Gas & Fuel Adjustor Included in Present Rates \$ -
Base Cost of Gas & Fuel Adjustor Included in Proposed Rates \$ -